PERSONAL FINANCE

529 Plans: A Powerful Way to Tackle Rising Education Costs

Contributions to 529 plans grow tax-free and are not taxed when they are used to pay for qualified educational expenses for the beneficiary.

When it comes to preparing to pay for a child's education, starting early can make a world of difference. With the rising costs of tuition and educational expenses, having a solid savings plan is essential to ease the financial burden and pave a smooth path for your child, grandchild, or someone else you care about.

One way to start saving in advance is to set up a 529 plan — a tax-advantaged investment account specifically for education-related costs. This plan derives its name from the IRS code under which it is authorized, Section 529. Every state (except for Wyoming and the District of Columbia) offers a 529 plan, each with its own variations. You do not need to be a resident of a particular state to establish a 529 plan in that state, allowing you to shop around and choose the best plan for your situation.

What you need to know before setting up a 529 plan

When you set up a 529 plan, you contribute after-tax dollars and, therefore, have no initial federal income tax ramifications. Over half of the states with plans offer a full or partial state income tax deduction or credit for 529 plan contributions, although some states limit the tax breaks to contributions to in-state plans.

The primary benefit of a 529 plan is that the contributed assets grow income- and capital gains tax-free in the 529 account and are not taxed when they are taken out as long as they are used to pay for schooling or other “qualified educational expenses” for the beneficiary. The avoidance of all taxes on earnings within the account provides a powerful incentive for people to start saving when the beneficiary is young and take advantage of assets compounding tax-free over time.

It is important to understand what counts as a qualified educational expense (QEE) because distributions for non-qualified expenses from a 529 plan will be subject to income tax on the investment gains as well as an additional 10% penalty. For college and vocational school, QEEs include the full amount of the tuition, books and supplies, computers, any special needs equipment as well as room and board if the student is enrolled at least half-time. They also include up to $10,000 in student loan payments and the cost of any apprenticeship programs.

For elementary and secondary schools, a 529 plan will cover up to $10,000 in tuition expenses per year (per beneficiary) for private, public or religious schools. For private secondary schools and boarding schools, this will generally not be enough to cover the full amount of the tuition, thus, additional planning beyond using a 529 plan may be needed.

Each 529 plan will offer a range of investment options, which include various mutual funds and exchange-traded fund (ETF) portfolios across different asset classes. Part of the process of selecting a plan is evaluating the available investment options and understanding the fees associated with them, as each 529 plan is different.

Contributing to a 529 plan

It is important to note there is a cap on the total amount that can be contributed to a 529 plan, regardless of who contributes to it. The contribution limits vary from state to state but are generally high; the total cap ranges from $235,000 to $530,000 in 2024. States do not impose annual contribution limits, meaning theoretically you could max out the plan in any one year. However, your contribution is treated as a gift to the beneficiary, making it subject to federal gift tax law. Accordingly, many contributors will make contributions each year up to

the applicable annual exclusion amount ($18,000 for an individual and $36,000 for a married couple in 2024) and fund a 529 plan account over a number of years.

Once a contribution has been made to the 529 plan, it is no longer part of the giftor's estate for tax purposes. This makes 529s a great way for parents, grandparents, aunts, uncles, godparents and friends to transfer wealth without paying estate tax upon their death.

For financial aid purposes, it may be more helpful to have the 529 plan owned by the grandparent (or someone else), not the parent. The value of a student-owned or parent-owned 529 plan is included as an asset on a student's FAFSA and thus might reduce the amount of aid a student is eligible to be given. However, a plan owned by a grandparent or other party is not included on the FAFSA and may be effectively ignored in the financial aid calculation.

Using 'unused' 529 plans

Owners of 529 plans frequently ask what happens if the money is not used for its intended educational purposes. For example, what if the beneficiary receives a scholarship, chooses an institution with less expensive tuition or simply decides not to pursue additional education? To avoid 529 dollars being "lost," the IRS allows the owner to change the beneficiary, as long as the new beneficiary is a "qualified family member" of the original beneficiary, not an unrelated individual (see note below).

As a result of the recently enacted SECURE 2.0 Act, unused dollars from a 529 plan can now be rolled into a Roth IRA tax-free up to $35,000 if the 529 plan has been in existence for 15 years and there have not been any contributions to the account within the last five years. The rollover is also subject to standard Roth annual contribution limits, so it would take several years to complete the maximum rollover of $35,000 from a 529 plan to a Roth IRA.

Benefits of contributing to a 529 plan:

- Tax-free asset growth within the account
- Flexibility to pay for qualified educational expenses (including room and board)
- High maximum total contribution limits
- Transferable to another qualified family member
- A portion can be rolled into a Roth IRA if certain stipulations are satisfied
- Can be used for elementary and secondary schools ($10,000 annual limit)

Considerations for contributing to a 529 plan:

- Contributions are subject to federal gift tax laws and limitations
- May reduce financial aid (student- or parent-owned plans are included in FAFSA calculation)
- Investment options are limited to those available through the state-sponsored plan

If you are starting to save early for education, a 529 plan can be a powerful way to tackle the rising costs of education with significant tax advantages and flexible usage for qualified educational expenses. Starting early can give your savings the time it needs to grow and benefit from compounding tax-free. While each state's plan varies and contribution rules apply, the ability to support a wide range of educational needs and even transfer funds to family members makes the 529 plan a robust option. By understanding the specifics of your plan and strategizing your contributions, you can maximize your educational investment and help secure a brighter future for those you care about.

The next article in this series will be a deep dive into Coverdell Education Savings Accounts.

Note: Qualified family members include the original beneficiary's spouse, child (or stepchild), sibling, aunt or uncle, niece or nephew, first cousin (as well as spouses of any of those mentioned). It also includes in-laws (sister, brother, mother and father).

About the Author

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Denise is a Director at Hirtle Callaghan with responsibility for leading family relationships from our Arizona office. Denise brings over 26 years of her legal and financial experience working with multigenerational client families on all aspects of their financial lives. Denise draws on her past experiences to help clients develop and implement their wealth transfer plans and makes recommendations about wealth transfer and tax-saving strategies. Denise obtained a juris doctorate degree from the Arizona State University College of Law and graduated magna cum laude with a bachelor's degree in accountancy from Arizona State University. She also obtained her Certified Public Accountant (CPA) designation (not currently practicing) and is a member of the Arizona Society of Certified Public Accountants. Outside of Hirtle Callaghan, Denise enjoys being active in the estate planning and philanthropic community.

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